

# Multilateral Disciplines for Investment-Related Policies

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Is there a strong case for developing countries to support the creation of a multilateral agreement on investment? Probably not. Existing agreements offer ample scope for liberalizing foreign direct investment in the area that matters most to developing countries: services.



## Summary findings

Hoekman and Saggi evaluate the potential benefits of international disciplines on policies toward foreign direct investment for developing countries. They conclude that the case for initiating negotiations on investment policies is weak, at present.

Negotiating efforts that center on further liberalizing market access on a nondiscriminatory basis — especially for services — are likely to be more fruitful in terms of economic welfare and growth.

Existing multilateral instruments, although imperfect, are far from fully exploited and provide significant opportunities for governments opening further access to markets.

Hoekman and Saggi conclude that priority should be given to expanding coverage of the General Agreement on Trade in Services (GATS) before seeking to negotiate general disciplines on investment policies.

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This paper — a product of Trade, Development Research Group — is part of a larger effort in the group to prepare for the next round of WTO negotiations. Copies of the paper are available free from the World Bank, 1818 H Street NW, Washington, DC 20433. Please contact Lili Tabada, room MC3-333, telephone 202-473-6896, fax 202-522-1159, Internet address [ltabada@worldbank.org](mailto:ltabada@worldbank.org). Policy Research Working Papers are also posted on the Web at <http://www.worldbank.org/html/dec/Publications/Workpapers/home.html>. The authors may be contacted at [bhoekman@worldbank.org](mailto:bhoekman@worldbank.org) or [ksaggi@mail.smu.edu](mailto:ksaggi@mail.smu.edu). June 1999. (29 pages)

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## **Multilateral Disciplines for Investment-Related Policies?\***

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JEL Classification: F13, F23, O19

Keywords: Foreign direct investment, WTO, multilateral trade negotiations

\* Presented at the conference Global Regionalism, Istituto Affari Internazionali, Rome, February 8-9, 1999. We are grateful to Byung-il Choi, Siow Chia, Zdenek Drabek, Paolo Guerrieri, Will Martin, Aaditya Mattoo, Marcelo Olarreaga, Arvind Panagariya, Jaques Pelkmans, Rolf Langhammer, Murray Smith, Bob Stern, Adel Varghese, Tony Venables, and Josef Yap for comments, suggestions and discussions.

## 1. Introduction

The value of sales by foreign affiliates of multinational firms now exceeds global exports of goods and services (UNCTAD, 1996). The observed growth in foreign direct investment (FDI) is a consequence of many changes in the world economy. Falling costs of communication have eased the constraints on global rationalization of production, leading to ever greater geographic specialization and international splicing of the production (value added) chain. Increased outsourcing and the information technology revolution have created markets for an ever expanding set of new services. Often such services cannot be traded, or suppliers must have a physical presence in a market in order to compete efficiently, further expanding FDI flows.

Market-driven changes in the economic environment have been complemented by changes in policies. Perceptions about multinational firms and their effects on host countries have undergone a transformation. Most countries are now quite eager to attract FDI; many offer financial incentives to attract FDI and have concluded bilateral investment treaties (BITs). As of 1999, over 1,600 BITs have been negotiated, compared to some 400 at the beginning of 1990 (UNCTAD, 1997). On the other hand, many countries continue to subject multinationals to performance requirements. For example, multinationals may have to comply with local content, export or technology transfer requirements. The schizophrenic nature of the overall policy environment reflects the guarded optimism with which many countries continue to view the entry of multinational firms into their territory.

At the 1996 WTO Ministerial meeting in Singapore, a working group on trade and investment was created to examine the relationship between trade and investment policies. A number of countries are in favor of introducing disciplines on investment policies into the WTO; others are opposed. This paper asks whether there is a strong case for developing countries to support the creation of a multilateral agreement on investment. We identify a number of potential gains from cooperation:

- Policies restricting entry by foreign firms may be welfare-reducing (resulting producer rents are less than consumer losses). If local incumbents capturing the rents are able to block FDI liberalization, an international agreement that grants foreign firms better market access or a “level playing field” could be beneficial to both host and source countries.
- Countries pursuing socially optimal policies may impose negative spillovers on other countries, or lead to an inefficient noncooperative outcome for the world as a whole (e.g., a prisoner’s dilemma). Possible examples are tax and subsidy competitions between governments and locational distortions created by regional integration agreements (RIAs) that encourage investment in “hub” countries and discriminate against FDI originating in non-members.
- Governments seeking to attract FDI may be pursuing all the “right” policies without generating a significant “supply response” because of a history of

policy reversals. If investors are risk averse, they may avoid the country altogether, impose large risk premia, not transfer “sensitive” technologies, etc. International agreement may then serve as a mechanism through which governments make irrevocable commitments and “guarantees” against policy reversals, thereby anchoring expectations of investors.

- Firms may confront significant transactions costs and uncertainty resulting from differences in national rules and bilateral investment treaties (BITs).
- Agreeing to investment disciplines can be as useful as a quid pro quo for a “grand bargain” that addresses major concerns of developing countries.
- The current hodge-podge of disciplines found in WTO agreements for goods as opposed to services makes little sense—it would be better to devise a set of common rules that are not product-specific, but activity-specific.

We conclude that although some of these potential rationales are compelling in principle, none justify multilateral negotiations on investment policies at this time. For the WTO process to “work”, foreign firms seeking better access to markets must be able to offer incentives to domestic groups in order to mobilize them to oppose existing restrictions. As developing countries are large net importers of FDI, this implies that the negotiating agenda must be expanded to include trade and other issues that allow side payments to be made to the relevant groups. In principle, this is readily done in the WTO context; indeed, it is one of the institution’s major strengths and a source of potential gains for developing countries (Hoekman, 1989). However, existing agreements already provide ample scope to pursue liberalization of FDI in the area where this matters most—services. The WTO General Agreement on Trade in Services (GATS) includes FDI as a mode of supply, and enormous scope still exists to liberalize FDI in services. We conclude that priority should be given to expanding the coverage of the GATS before seeking to negotiate general disciplines on investment policies.

The negative spillover case for cooperation is weak. Many studies conclude that investment policies are largely redundant (ineffective). If so, there should be no spillovers and governments should simply refrain from pursuing discriminatory FDI policies. Recent deliberations in the WTO Working Group illustrate that many governments believe incentives are effective and important instruments to attract FDI, and some studies support that view. If so, negative spillovers are certainly possible, but, if there are positive externalities for host countries due to FDI, it may make good sense for governments to compete for it. This is because their rivalry could lead to a better allocation of FDI than might arise in the absence of such competition. Thus, whether incentives work or not, there is no clear case for international cooperation that restricts the ability of governments to pursue national policies.

Governments may also pursue policies that aim to shift profits from foreign firms to the host economy. If successful, this is to the detriment of source countries. As developing countries are not major exporters of FDI, this is a zero-sum type of game: no cooperative solution exists if the negotiating agenda is limited to investment policies

only. Expanding the negotiating set to include issues of interest to developing countries can in principle allow an agreement to be crafted that improves the welfare of all parties. However, when markets can be contested effectively via exports, strategic profit-shifting investment policies can only be effective if they are supported by restrictive trade policies (or else foreign firms can always opt for exporting). The further the WTO goes in reducing and binding trade barriers, the less scope there is for profit-shifting policies to be effective. Thus, profit-shifting-related externalities can largely be addressed through existing WTO mechanisms under the GATT and the GATS.

Countries that have credibility problems can seek to address these through a wide variety of actions, including using existing international institutions such as the WTO and international institutions that provide arbitration services. The WTO offers ample scope to bind trade-related policies, as well as investment restrictions for services. Most countries are far from utilizing them fully. This suggests that credibility may not be as important to governments as is sometimes argued or that international agreement is not an effective vehicle for overcoming political opposition to actions that reduce the scope for government intervention. Policy-related transactions costs will be relatively minor for multinationals compared to all the other costs associated with FDI and do not justify multilateral harmonization attempts.

The “grand bargain” argument has always been a *raison d’être* of the WTO. While valid in principle, it is not clear that investment policies are that valuable a “negotiating chip” for developing countries compared to, e.g., liberalization of trade under existing agreements (GATT and GATS). Investment may prove useful at the margin, but much can already be brought to the table by utilizing existing mechanisms. Finally, the architectural argument is perhaps the most compelling rationale for launching negotiations. But in that case the issue should be framed in architectural terms, aiming at a redesign of the WTO in toto.

Given that there exists ample room to pursue liberalization via existing agreements, we conclude that priority should be given to continuing the process of multilateral trade liberalization, focusing attention as far as investment (establishment) policies are concerned in sectors where FDI is critical as a mode to contest markets, i.e., services. The GATS already covers investment as a mode of supply for which market access and national treatment commitments can be made on a sector-specific basis. Thus, a large proportion of the potential gains from negotiations focusing on liberalization of FDI can be realized through full exploitation of existing multilateral instruments.

The paper is organized as follows. We start with a brief discussion of the rationale for policies that restrict FDI and summarize existing WTO rules and disciplines (Section 2). We then turn to the “spillover” case for international cooperation and discuss the economic rationale for financial and fiscal incentives designed to attract FDI (Section 3). Next, we turn to the issue of discrimination arising from RIAs (Section 4), followed by the case for international agreement as a strategy to gain credibility and the transaction costs argument (Sections 5 and 6). The “grand bargain” and WTO architecture arguments

are the focus of Sections 7 and 8. The recent OECD effort to negotiate a Multilateral Agreement on Investment (MAI) is discussed in Section 9. We then summarize the implications of our argument for the value to developing countries of a stand-alone multilateral agreement on FDI at this time (Section 10) and offer some concluding remarks (Section 11).

## **2. Restrictive Policies Toward FDI: Market Access**

Policies toward FDI exhibit considerable variation over time and space. In countries that historically emphasized import substituting industrialization, FDI was typically not allowed or multinational firms had to operate under severe restrictions. Even in countries where technology acquisition was a major concern of governments, multinationals were rarely permitted to operate wholly owned subsidiaries. For example, Japan, Korea, and Taiwan imposed restrictions on FDI at various points in time, even though foreign trade was viewed positively.

In recent years, government policies toward FDI have been liberalized across the world (UNCTAD, 1992). This trend reflects an increasing awareness on the part of many governments that multinational firms play an important role in economic development by serving as conduits of superior technology as well as management techniques. While there has been an overall change of attitude towards FDI, many countries—both industrialized and developing—continue to restrict the conduct of multinationals and/or subject them to various performance yardsticks. Examples include equity ownership limits, licensing regimes and export or local content requirements. In other words, the perception seems to be that while increased FDI is desirable, the conduct of multinational firms may have to be subjected to regulations and restrictions in order to maximize benefits for the host country—assuming such indeed is the motivation behind the various measures instituted by host countries.

Investment measures have tended to be concentrated in specific industries with automotive, chemical, and petrochemical and computer industries leading the list (UNCTAD, 1996). Local content requirements are most important in the auto industry (Pursell, 1999); export requirements are more important in the computer industry. In chemicals and petrochemicals, local content requirements and export requirements are employed extensively. The type of policy often depends on whether FDI is resource-seeking, domestic market oriented, or export-oriented (Caves, 1996).

Economic theory dictates that when domestic distortions and externalities from FDI are both absent, the optimal FDI policy ought to be no policy at all—i.e. governments should allow for unfettered market transactions. For example, under perfect competition, domestic content protection raises the price of domestic inputs, by requiring multinationals to use more of them, and thus benefit input suppliers at the expense of final goods producers (Grossman, 1981). For there to be a rationale for policies restricting FDI there must be domestic policy distortions or market failures. Since multinational firms typically arise in oligopolistic industries, the usual example of a market failure is

the presence of imperfect competition in the host economy.<sup>1</sup> Multinational enterprises (MNEs) may have market power and use this to extract rents from the host economy. Or they may maximize profits by engaging in practices that limit “leakage” of know-how to competing local firms.

Analyses of content protection and export performance requirements under conditions of imperfect competition (Richardson 1991; 1993; Rodrik 1987) illustrate that the welfare effects of such policies may not be necessarily negative.<sup>2</sup> However, in most situations more efficient instruments than investment measures can be identified to address a market failure, including vigorous competition policies. In the case of domestic policy distortions, the optimal policy is well known: remove them at the source, if necessary through appropriately designed regulatory intervention that is applied on a nondiscriminatory basis (i.e., applies equally to both foreign and domestic firms). Thus, rather than use investment policies to offset the effects of high protection, adoption of low and uniform tariffs would be preferable. This point of view is implicit in the WTO, which not only aims at progressive liberalization of trade, but also prohibits the use of most trade-related investment measures (TRIMs).

In the Uruguay Round an agreement on TRIMs was negotiated that prohibits measures that are inconsistent with the GATT national treatment principle (Art. III) or the prohibition on the use of quantitative restrictions (Art. XI). The TRIMs agreement includes a list of prohibited measures (including local content, trade-balancing, foreign exchange-balancing and domestic sales requirements), requires that all policies not in conformity with the agreement be notified within 90 days of entry into force of the agreement, and that they be eliminated within two, five or seven years, for industrialized, developing and least developed countries, respectively. The agreement is to be reviewed in the year 2000 at which time it may be complemented by provisions on competition and investment policy (Low and Subramanian, 1996).

It is sometimes not realized that the TRIMs agreement does not go beyond existing GATT rules—it simply re-iterates that the GATT national treatment principle and the prohibition of quantitative restrictions apply to trade-related investment policies. These disciplines are quite powerful. The GATT has been a constraint on countries using TRIMs, and can be expected to become a more serious source of discipline in future as Uruguay Round transition periods for developing countries expire. A recent case brought by the EU, Japan and the US against provisions of the National Car Program introduced

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<sup>1</sup> However, this is not required. The standard example of a policy distortion is trade protection. Consider a developing country with protection on the capital intensive good in a standard two sector, two factor model. Allowing in foreign capital causes the output mix to shift towards the capital intensive sector, so that imports of the capital intensive good and therefore tariff revenues fall. This reduces welfare because each unit of imports is worth more inside the country than its cost from world markets (Hamada, 1974; Minabe, 1974). For papers that explore these types of models in greater depth, see Bhagwati and Brecher (1980), Brecher and Diaz-Alejandro (1977) and Brecher and Findlay (1983).

<sup>2</sup> As is well known, in the presence of pre-existing distortions, introducing another distortion, say in the form of a content protection scheme, can raise welfare.



by Indonesia in 1996 may be indicative of the future. Under the contested program, the government granted “National Car” company status to Indonesian companies that met specified criteria as to ownership of facilities, use of trademarks, and technology. National Cars companies were required to meet increasing local content requirements over a three year period; if so, they benefited from exemption from the prevailing luxury tax on sales of cars and exemption from import duties on parts and components. “National Cars” manufactured in a foreign country by Indonesian nationals and which fulfilled the local content requirements prescribed by the Minister of Industry and Trade were also exempt from import duties and luxury tax. Such imported National Cars were deemed to comply with the 20 per cent local content requirement for the end of the first production year if the value of “counter-purchased” Indonesian parts and components accounted for at least 25 per cent of the value of the imported cars (WTO, 1998b). The panel found that this program violated the TRIMs Agreement (national treatment).

More disputes may arise under the TRIMs agreement once the transition periods for full compliance on the part of developing countries have expired. A major reason Indonesia was “targeted” was that the policy measures were introduced after the entry into force of the TRIMs agreement. A number of countries apply similar policies but are sheltered by the transition period.

While in many situations TRIMs are second best instruments, policy intervention in oligopolistic markets can improve local welfare by altering the distribution of product market rents between domestic and foreign firms. Policy may also be driven by distributional concerns. Suppose, following Glass and Saggi (1999b), one imagines an economy with an oligopolistic sector (manufacturing) and a numeraire sector (agriculture). Inward FDI into the manufacturing sector generates increased demand for skilled labor, which benefits skilled workers through raising wages in the host country but consequently damages the profits of host firms (positive due to imperfect competition). The tension between wages and profits implies that government policies toward FDI benefit one group at the expense of the other and the relative importance of the welfare of the two groups (as captured in the government’s objective) then determines the policy stance implemented by the government. If the economic environment of a country is such that profits of local firms are unimportant because local industries are largely foreign owned (so that national income largely consists of wage earnings), the country is likely to take a favorable view of inward FDI: the loss in profits accruing to domestic agents incurred due to the increased entry of multinationals is small relative to the benefit accruing to workers. However, when local profits matter, the policy stance toward FDI may be more restrictive.

There are therefore circumstances where the optimal policy may be to restrict FDI. If all countries pursue such policies, the outcome will typically be inefficient from a world welfare point of view. Cooperation that involves agreement not to restrict FDI can then be Pareto improving. Alternatively, the situation may be zero sum, in which case there are no gains from cooperation. If so, any international agreement will have to

extend beyond investment policies to allow side payments to be made (more on this below).

A necessary condition for cooperation to be beneficial is that restrictive policies have their intended effect. In many cases, surveys show that investment measures require firms to take actions that they would have taken anyway. For example, a policy that requires firms to export is inconsequential if firms were going to export even in the absence of such a requirement. Surveys by the US Department of Commerce for 1977 and 1982 indicated that only six percent of all the overseas affiliates of US firms felt constrained by TRIMs such as local content requirements, although a far greater percentage operated in sectors where TRIMs existed. In other words, TRIMs often failed to bind (UNCTC, 1991a).

Of course, TRIMs are just part of the relevant policy landscape, and the forgoing surveys do not take account of the firms that might have invested but decided not to because of TRIMs. Investment measures are often general, not trade-related. Many countries apply licensing and approval regimes and impose related “red tape” costs on foreign investors. They may also prohibit entry through FDI altogether, or impose equity ownership restrictions. Such policies may reflect welfare-enhancing attempts to shift foreign profits to the domestic economy or welfare-reducing rent-seeking activities by bureaucrats and their constituents. Sometimes the effect of policies is simply to waste real resources (so-called frictional costs—see Baldwin, 1994). The TRIMs agreement does not apply to such non-trade-related policies, nor does it affect service industries. The latter are covered by the GATS, however, which extends to FDI policies in that countries can make specific market access and national treatment commitments for this “mode of supply” for any or all services.

Investment policies that seek to transfer rents from foreign to domestic firms or other constituencies are discussed further in Section 3, as they are one potential source of negative policy spillovers. Whatever the economic rationality of restrictive policies, the available empirical evidence suggests that local content and related policies are ineffective and costly to the economy—they do not achieve the desired backward and forward linkages, encourage inefficient foreign entry, and create potential problems for future liberalization as those who enter lobby against a change in regime (Moran, 1998). Governments that recognize that *status quo* FDI policies are costly to the economy may face political impediments in eliminating them because protected industries are able to prevent their abolition. International agreement may be valuable in helping to overcome this resistance.

Any rents associated with restrictive FDI policies will be eroded in tradable industries if a liberal trade policy stance is pursued, as foreign firms can then contest the market through exports. This suggests priority be given to trade liberalization and trade facilitation efforts (enhancing the efficiency of customs clearance and port services). If trade barriers are low, domestic industry will not have as large an incentive to support restrictive FDI regulations (restrictions on inward FDI may be motivated in part by the

existence of high trade barriers, as this provides an incentive for tariff-wall hopping FDI). More generally, if multilateral negotiations on investment policies are to assist governments seeking to liberalize or improve FDI policies, the negotiating agenda will have to include topics that are of sufficient interest to the relevant domestic groups to induce them to support a pro-reform agenda. Limiting tradeoffs within the investment policy area is unlikely to be effective in this regard for most developing countries as they are primarily “importers” of FDI. Given an absence of FDI “export” interests, the necessary carrots will lie outside the investment area.<sup>3</sup>

In the case of nontradables such as many service industries, liberalization of entry and operating restrictions is of much greater importance in terms of market access than it is for tradables. In many cases local incumbent firms will be enjoying significant rents, and will oppose new entry by foreign firms. Here again there is a potential rationale for multilateral negotiations, as the desire of foreign firms for market access can be used as a tool to promote liberalization, but here again there may be a need to expand the negotiation set to include other issues.

### **3. Market Failures and International Spillovers**

Investment-related policies may reflect attempts to shift rents from source to host countries or a desire to secure benefits to the local economy that may potentially go elsewhere. Both types of policies can create international spillovers and provide a basis for international cooperation.<sup>4</sup>

#### *Investment policies with strategic objectives*

Since multinational firms are pervasive in oligopolistic industries, incentives to shift profits or rents from MNEs to the host economy are not a mere theoretical possibility. The distribution of rents between governments and large multinationals has always been a classic controversy. In contrast to industrialized countries, where two way flows of FDI are large, developing countries are large net importers of FDI and it is precisely in developing countries that multinationals have been controversial. Most developing countries do not export any FDI at all and are unlikely to do for quite some time into the future. Thus, developing countries squarely represent only the host country view of FDI. Consequently, it will be very difficult to devise an international agreement on investment that is welfare-enhancing for developing countries that successfully

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<sup>3</sup> Developed countries with large stocks of two-way FDI should in principle find it easier to achieve gains from cooperation that is limited to FDI policies as each will be both a source and destination country.

<sup>4</sup> In a multi-country world, a selective use of investment incentives can also have strategic consequences. An exporting foreign firm from a third country (or a local host firm) may find itself at a disadvantage with respect to a foreign firm that experiences a decline its cost due to an investment incentive. Thus, the dichotomy between incentives and strategic investment policies is not clear cut. The distinction is made here to isolate the primary motivation behind each policy: incentives are intended to lure in multinationals while policies restricting their behavior are means for altering the distribution of rents. See Glass and Saggi (1999b) for a model in which investment subsidies have strategic consequences. Of course, discrimination via taxation can also have rent shifting consequences.

employ policy strategically. In this case a cooperative solution requires that the negotiating agenda be expanded to include issues of interest to developing countries (Hoekman, 1989). Of course, it is not clear how many countries are in this group—as has been emphasized repeatedly in the literature, in practice it will be very difficult for policymakers to apply such policies well. The informational requirements are very substantial, policies can easily be captured by industries, and account must be taken of the reactions of affected firms and their home governments. The best rule of thumb for policymakers to apply in most situations is to refrain from pursuing strategic policies.<sup>5</sup>

Whether strategic investment policies are applied or not, they are bound to be second-best tools from an economic viewpoint if the products involved are tradable. The reason is quite straightforward—the realization of profit-shifting objectives requires trade policy instruments. If a country pursues free trade, investment measures will have only a limited effect at best, as foreign firms can choose to service the market through trade instead of FDI. Only to the extent exports are a second best means of servicing markets will investment policies shift rents toward domestic firms. Conversely, if trade policy has a strategic objective, investment measures are redundant. The implication of this is that the existing WTO is the main instrument through which to pursue efforts to discipline strategic FDI policies for tradable industries. From this perspective it is not surprising that TRIMs are covered by the GATT (and have been from the very start).<sup>6</sup>

Sometimes FDI is the only means of servicing a market. If so, foreign firms may have to suffer the consequences of strategic investment policies without any possible recourse to trade.<sup>7</sup> Thus, an investment agreement may be needed primarily in the case of services. The question then becomes what can one expect from an investment agreement relative to GATS.

### *Investment Incentives*

Incentives may be justified if there exist externalities from FDI. For example, developing countries hope FDI will generate technological spillovers for local firms thereby making more efficient use of existing resources.<sup>8</sup> There exists a large literature that tries to determine whether or not host countries enjoy ‘spillovers’ (positive

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<sup>5</sup> It is quite easy to get it wrong even in circumstances where the optimal policy appears straightforward. See for example the case study of Madagascar’s policy towards controlling exports of vanilla (De Melo, Olarreaga and Takacs, 1999).

<sup>6</sup> If FDI is in the import-competing sector, then the trade policy to use to tax FDI is an import-subsidy—something that is not of concern to the WTO. If FDI is in the export-competing sector, a tariff can shift resources from foreign affiliates to domestic factors in other sectors (Olarreaga, 1998). A binding free trade regime locked in through the WTO would not allow this.

<sup>7</sup> One common policy has been to favor joint ventures relative to wholly owned subsidiaries. Whether such policies are motivated by the desire to force multinationals to share rents with local partners or to encourage technology transfer to local firms (or both) is not clear. What is clear is that, if left free to choose, multinationals usually prefer wholly owned subsidiaries, hiring any local expertise that is needed directly in the form of employees rather than acquiring it via a partnership.

<sup>8</sup> The usage of the word ‘spillovers’ is somewhat unfortunate since productivity improvements are unlikely to be costless and automatic.

externalities) from FDI (Caves, 1996; Blomstrom and Kokko, 1997; and Markusen, 1998 provide excellent surveys). The central difficulty is that spillovers, by their very nature, often do not leave a paper trail—they are externalities that the market fails to take into account. At a general level, the literature suggests the following potential channels of spillovers:

- *Demonstration effects* – local firms may adopt technologies introduced by the multinational through imitation or reverse-engineering.
- *Labor turnover* – workers trained by the multinational may transfer important information to local firms or may start their own firms leading to diffusion of technology.
- *Linkages* – derived demand (both upstream and downstream) by multinationals may lead to local provision of services or inputs that can also be used by local firms.

In its simplest form, the demonstration effect argument states that the close proximity to multinational firms may lead to efficiency gains by local firms who may modify their own production methods upon exposure to the superior technology of multinationals. One must be careful, however since a mere expansion in choices need not imply externalities, especially if incentives for adoption are also affected by multinational enterprises (MNEs). FDI may expand the choice set but it generally also increases competition, so that the net effect on the incentive to adopt new technologies is ambiguous (Glass and Saggi, 1999a). However, if competition reinforces the incentives for adoption, FDI may indeed spur local incentives (Das, 1987; Wang and Blomstrom, 1992).

Some empirical support for positive effects is found by Blomström, Kokko and Zejan (1994) and Blomström and Persson (1983). Studies using firm level data are less supportive of the spillover hypothesis: Aitken, Hanson, and Harrison (1997) and Haddad and Harrison (1993) actually find that foreign investment has a negative effect on the performance of domestically owned firms. One needs to be cautious in interpreting these findings. Case-study evidence is strongly suggestive of spillovers (see Schive, 1990) and a more complete econometric study would require a more dynamic approach: it is very unlikely that significant improvements in the productivity of local firms can be realized without costly investments that yield payoffs in the future.

The type of FDI may also matter importantly. Djankov and Hoekman (1999) find that foreign investment has a negative spillover effect on firms in Czech industry that do not have foreign partnerships. This effect is relatively large and statistically significant. However, if joint ventures are excluded and the focus of attention is restricted to the impact of majority-owned foreign affiliates (i.e., FDI) on all other firms in an industry (including joint ventures), the magnitude of the negative effect becomes much smaller and loses statistical significance. This result illustrates that the initial negative spillover result may not be robust and that tests for spillovers with the methodology used in the literature require some assurance that in distinguishing between two subsets of firms in an

industry on the basis of whether or not there is foreign ownership one is not ignoring other important determinants of the performance of firms such as the technological effort of firms. Survey questionnaires reveal that joint venture firms invested significantly more in training and new technologies than pure “domestic” firms. It may be that the technological ability of the firms without foreign partners is too low to be able to absorb spillovers when they occur, or that the firms with foreign linkages have absorbed a significant share of the available stock of labor with requisite skills.

Empirical evidence regarding the magnitude of labor turnover from multinationals to local firms is mixed. Gershenberg (1987) finds limited evidence of labor turnover from multinationals to local Kenyan firms, while studies of Asian economies document substantial labor turnover from multinational to local firms (UNCTAD, 1992, Bloom, 1992, Pack, 1997). These conflicting findings may reflect the fact that in countries such as South Korea and Taiwan, local competitors are less disadvantaged relative to their counterparts than in many African economies, thereby making labor turnover possible. Thus, the ability of local firms to absorb the technologies introduced by multinationals may be a key determinant of whether or not labor turnover occurs as a means of technology transfer in equilibrium (Glass and Saggi, 1998).

Several recent studies document that multinationals pay higher wages than local firms. Using data from Mexico, Venezuela, and United States, Aitken, Harrison, and Lipsey (1995) show that higher levels of foreign investment are associated with higher wages in all three countries. The implication of this fact is that if multinationals raise wages in order to restrict technology transfer to local firms and given that the wage premium has no necessary relation to the social value of the knowledge embodied in workers, technology transfer is not necessarily optimal for the local economy. Thus, policies to encourage technology transfer may not raise welfare of the recipient country.

Finally, multinationals may generate externalities through backward and forward linkages. Rodriguez Clare (1996) makes the important point that multinationals improve welfare only if they generate linkages over and beyond those generated by local firms they displace. Markusen and Venables (1999) have argued that the entry of multinationals might help resolve a coordination failure in the host economy. By creating demand for intermediate goods, entry by multinationals encourages their production. Consequently, local firms gain access to hitherto unavailable inputs since these are not produced in the absence of the demand generated by multinationals. Such an argument is probably most relevant for the least developed countries that have very little industrial activity of their own. Countries like India and Brazil that have adequate indigenous industry are less likely to enjoy substantial linkage effects of this kind. In both types of countries increased imports of intermediate inputs following MNE entry and more general trade liberalization can enhance the process of industrialization (Puga and Venables, 1998).

Although an economic rationale for providing incentives to FDI exists in the presence of domestic distortions or positive externalities, the empirical evidence regarding the efficacy of financial incentives to attract FDI is ambiguous due to the nature

of externalities and the need for dynamic study (as immediate productivity improvement in local firms is unlikely). If one accepts the notion that there is a solid economic case for promoting inward FDI via incentives because of positive externalities, countries may find themselves in a bidding war for attracting FDI. This can be to the detriment of the parties involved if it leads to “excessive payment” to the investor. If this is an important possibility, there is a potential case for international cooperation to ban or discipline the use of fiscal incentives.

Clearly a key issue is whether fiscal incentives are effective. Many studies have concluded that offering fiscal incentives to inward FDI is not effective once the fundamentals that determine FDI are taken into account (see Caves, 1996 for a survey). These studies suggest financial incentives basically end up as transfers to multinationals without influencing location decisions. If this is true it implies that there is no good case for international cooperation: if financial incentives are ineffective, there is no rationale for seeking multilateral disciplines prohibiting fiscal incentives as it is in each countries self-interest not to offer them. From an efficiency stand point, if fiscal incentives fail to alter the pattern of FDI, they fail to be distortionary. On the other hand, it is precisely when such incentives fail to attract FDI that the developing countries have the most to gain from refraining to use them: in such situations they are pure transfers from developing countries to multinationals.

Government officials are often not convinced of the inefficacy of incentives, as illustrated by statements by a number of representatives in the WTO Working Group on Trade and Investment (WTO, 1998a). To some extent this may reflect differences in views regarding what is meant by an incentive. Of great importance is to distinguish between fiscal and financial incentives and more general policies that promote business activity. That the latter matter a lot in attracting investment is uncontested—they are a key dimension of the economic fundamentals.<sup>9</sup> Clearly there is also a rationale for the pursuit of policies that will facilitate the adoption and adaptation of know-how. Such general (horizontal) incentives that apply across-the-board are a key element in defining the business environment, and are an important determinant of the “fundamentals” that prevail in an economy (e.g., the absence of red tape; adequate infrastructure; training and education programs, etc.). It is important to make a distinction between fiscal or financial incentives that are firm-specific, and these more general economy-wide policies.

That being said, there is some evidence that suggests fiscal incentives do have an effect on location decisions, especially for export-oriented FDI, although it is by no means the key factor (Guisinger et al. 1985, Hines, 1996, Devereux and Griffiths, 1998).<sup>10</sup> There are also models in the agglomeration literature that generate low-level equilibrium

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<sup>9</sup> As illustrated in a recent empirical analysis of the effect of US state-level policies on the location of manufacturing investment. Holmes (1998) found that the share of manufacturing in employment in states with pro-business regulatory environments increases by one third compared to a bordering state without such policies.

<sup>10</sup> Fiscal incentives are found to be unimportant for FDI geared towards the domestic market. This type of FDI is more sensitive to the extent to which it will benefit from import protection.

“traps” and provide a rationale for incentives in order to get over a critical mass threshold required to attract firms to a location. Given the difficulty of quantifying the positive externalities associated with inward FDI, determining the optimal incentive is obviously very difficult. But in principle, if governments compete for FDI, this can help ensure that FDI goes to those locations where it is most highly valued. This economic case for “subsidy freedom” has been made by Bond and Samuelson (1986), who argue that incentive competition can act as an efficient signaling device that improves the allocation of investment across jurisdictions by ensuring that FDI moves to where it has the highest social return. Note that in such situations governments should pursue policies on a nondiscriminatory basis—in particular, abiding by the national treatment principle and adopting a right of establishment would appear to be appropriate.

This is not to say, of course, that locational competition is not detrimental to developing countries. Of particular concern are efforts by high income countries to retain or attract FDI that would be more efficiently employed in developing countries. Labor unions and groups representing the interests of local communities may oppose plant closures and efforts by firms to transplant facilities. Similar motivations underlie the use of trade policy instruments such as antidumping. It is important to distinguish between locational competition which may be efficient and locational competition that relies on the use of trade policy such as antidumping. The latter is inherently inefficient in focusing on the protection of industries that cannot compete and inducing a variety of ancillary distortions that are well documented in the literature (e.g., Finger, 1993).

The foregoing suggests there are valid reasons to question the rationale for an agreement that seeks to discipline incentives. If incentives are ineffective, there are no real negative spillovers. If they are effective, a good case can be made for subsidy freedom. The latter argument is bolstered by practical considerations: it will be very difficult to enforce any agreement that restricts locational incentives as governments have multiple instruments available, including their tax regimes.

#### **4. Spillovers Associated With Regional Integration**

Some RIAs have extended the reach of national treatment to investors from partner countries, in the process abolishing performance criteria and related policies such as local content and trade balancing requirements. Examples include the EU, where freedom of investment is a basic principle, NAFTA, and various association agreements the EU has concluded with Central and Eastern European neighbors. Insofar as RIAs lead to discrimination between insiders and outsiders in terms of FDI policies, they impose negative externalities over and above whatever investment “diversion” occurs because of the preferential liberalization of trade barriers. Eliminating this discrimination can be a powerful argument in favor of multilateral rules. An important empirical question is whether such discrimination occurs and how large it is. This is very difficult to determine, as it requires careful and detailed assessments of the applicable legislation on both a horizontal and sector-by-sector basis. Some agreements—e.g., the EC and some of the agreements it in turn has negotiated with neighboring countries—embody a right of



establishment for nationals of parties. Most RIAs are limited to BIT-type disciplines, requiring national treatment (often subject to exceptions—negative lists) and disciplining the use of performance requirements. Given the role of regulation and the political sensitivity associated with foreign ownership of many service industries, one way of assessing whether RIAs have a discriminatory effect is to determine to what extent they go beyond the GATS in elimination of discrimination in service markets. Given that FDI will be a major mode of supply, the more RIAs go beyond the GATS, the greater the potential negative spillovers.<sup>11</sup>

In the EU, there is in principle full freedom to provide services. However, in practice this proved difficult to achieve as national monopolies and licensing/certification requirements constituted major barriers to cross-border movement. It was only with the Single Market or '1992' program that a concerted effort was made to integrate EU services markets. All other RIAs are much less far-reaching than the EU, not least because they do not involve the supra-national institutions that played a major role in the EU in pursuing the integration objective. The NAFTA has comprehensive coverage of services activities, and liberalizes both cross-border trade and investment in services, but subject to significant derogations, exceptions and reservations. The Australia-New Zealand Closer Economic Relations (CER) trade agreement has also liberalized trade in most service sectors subject to a negative list of exceptions. In contrast to NAFTA there are no exemptions of indefinite duration: the agreement contains provisions that aim at removing reservations over time, something that has been occurring steadily over time (Hoekman, 1999).

No specific commitments are made in the Euro-Mediterranean agreements on liberalization of cross-border supply of services (i.e., trade), nor is there a right of establishment (Galal and Hoekman, 1997). Liberalization in these areas is an objective that is to be pursued in the future; commitments are limited to the obligations of each Party under the GATS, which does not imply much, if any, liberalization. In the case of the ANDEAN pact, the Central American Common Market (CACM), or the Southern African Development Community (SADC), little services liberalization has occurred. In MERCOSUR, free circulation of services is a long term objective to be achieved by 2007. Progress towards liberalizing service markets has been slow, with members still engaged in a process of negotiating a framework agreement for liberalization in this sector. ASEAN members only agreed in 1997 to aim for full liberalization on a preferential basis of most services by 2020.

Thus, with the notable exception of the EU, trailed by CER and NAFTA, it appears that the multilateral GATS process is either leading liberalization of services, or that GATS commitments of RIA members do not differ significantly from their RIA commitments (Hoekman 1999). Thus, there is not much evidence of large negative spillovers resulting from RIAs as far as investment is concerned. Most RIAs also do little

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<sup>11</sup> Of course, RIAs may have negative effects on nonmembers (trade diversion), and may also have the effect of increasing FDI inflows into member countries from both members and nonmembers. The focus here is on the existence of explicit discrimination.

to effectively constrain the ability of governments to provide incentives for FDI. The most far-reaching RIAs are those involving the EU as a partner. They seek to apply common disciplines in areas such as antitrust, state aids, and state monopolies; indeed, increasingly what appears to be required is the full adoption of the EU's internal market rules. Periodic disputes regarding the use of incentives by local governments to attract FDI and recurring claims of "social dumping" illustrate that even the far-reaching EU disciplines are insufficient to constrain the ability of governments to adopt the tax and factor market policies they believe will be most conducive to stimulating investment, be it foreign or domestic.

Insofar as RIAs cause negative investment spillovers—and there is evidence that they do—this will be attenuated if the associated trade discrimination is eroded. This will occur if the RIA reduces external tariffs and other trade barriers. The focus of multilateral negotiation efforts should therefore be on multilateralization of intra-regional liberalization so as to minimize discrimination and reduce the need for restrictive rules of origin (another instrument of investment diversion). This is likely to be a more feasible and productive strategy than attempting to strengthen the WTO's disciplines on regional integration (Winters, 1999).

## **5. Reputation and Policy Credibility**

From a national perspective, a multilateral agreement may help countries that seek FDI as a signaling device or instrument through which the perceived credibility of a set of policies intended to foster FDI can be enhanced. It is sometimes argued for example that the countries of Central and Eastern Europe sought to conclude Association Agreements with the EU in part to overcome perceptions by foreign investors that they were countries where there was a high risk of policy reversals and policy uncertainty.<sup>12</sup> In order to assess the relevance of the "credibility argument" for an investment agreement, it is necessary to identify how much of what might be embodied in such an agreement can be pursued and implemented unilaterally, and, as important, to control for the economic fundamentals. The experience of transition economies reveals that fundamentals are crucial. Some countries with Association Agreements have attracted very little FDI (e.g., Bulgaria) in large part because privatization was not pursued with any vigor, the political environment was uncertain, and macroeconomic policy such that inflation attained triple digits. The Czech Republic, Hungary and Poland have attracted significant FDI inflows, but it is unclear what role the investment provisions of the Association Agreements have played. A case can be made that fundamentals drove these inflows, including privatization, re-establishment of private property rights, and geographic proximity to Europe (especially Germany).<sup>13</sup>

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<sup>12</sup> See Markusen (1998) for a discussion of the "credibility case" for an investment agreement; Fernandez and Portes (1998) for an analysis of how international agreement may support credibility.

<sup>13</sup> See Hoekman and Djankov (1997) for an empirical analysis.

Many countries that are looking for FDI have made use of a variety of existing “credibility-enhancing” institutions. One is to commit to accept arbitration of disputes under the Convention on the Settlement of Investment Disputes between States and Nationals of Other States (ICSID), by the International Chamber of Commerce (ICC), or by the UN Committee on International Trade Law (UNCITRAL),<sup>14</sup> depending on the preferences of the investor. Sometimes such commitments are embedded in RIAs—e.g., NAFTA. Developing countries may also negotiate bilateral investment treaties with the major home countries of FDI.

Countries that are “in the market” for credibility can also use the existing WTO disciplines to schedule market access opening policies for services (including granting of the right of establishment), and choose to lock in low tariff regimes by binding these under GATT rules. There is still huge scope for developing countries to use the WTO as a credibility enhancing instrument—as noted previously, the coverage of services commitments is very limited, and tariff bindings for merchandise imports are often significantly higher than applied rates. Although credibility with respect to investment-related policies can also be pursued via a multilateral investment agreement, those governments that are convinced they have a need to use external instruments to achieve such objectives could start by exploiting existing instruments much more fully.

## **6. Transactions Costs Arguments for Harmonization of FDI Policies**

Governments pursue different policies towards FDI and subject investors to idiosyncratic regulations. As a result, investors that establish a presence in multiple jurisdictions are confronted with higher transactions costs than if a global harmonized set of rules were to exist. As mentioned in the Introduction, some 1,600 BITs are in force, and these also differ across countries and country-pairs, so that foreign investors are confronted with differences in the legal security offered by these instruments. Governments are also confronted with negotiating costs associated with having to establish a series of BITs with the major source countries, and must consider that industrialized country partner governments may seek to exploit their greater “market power” to shift the “terms of trade” to their advantage (e.g., by insisting on provisions that are detrimental to the host country).

Clearly the need to negotiate BITs will give rise to transactions costs for firms and governments, but it is not clear how significant these costs are relative to the counterfactual situation of a “global BIT”. This issue is especially relevant if there are reasons to doubt the outcome of such negotiations, as there should be given the experience of the OECD. Furthermore, most BITs are rather similar in that they deal with ensuring non-discriminatory treatment for investors once they have established/invested,

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<sup>14</sup> An International Centre for the Settlement of Investment Disputes operates under the aegis of the World Bank to apply the Convention. The ICC has a Court of Arbitration. UNCITRAL has adopted a set of Arbitration and Conciliation Rules that can be used in the settlement of commercial disputes.

and address issues such as dispute settlement and arbitration. With the notable exception of BITs negotiated by the US, they do not generally address the question of liberalizing market access. Even assuming that a global BIT would do the same, a case can be made for diversity, and letting countries design and negotiate BITs in an unconstrained way. This will ensure that host governments retain their freedom to reflect differences in national preferences and conditions. Given the existence of international institutions that provide arbitration services such as the ICC and ICSID, governments can decide unilaterally whether it is in their interest to use them.

Regarding the costs imposed by the multitude of BITs on multinational firms, it seems that the major proportion of the transactions costs associated with FDI is likely to arise from differences in language, culture, politics, and the general business climate of a host country. Familiarizing oneself with the investment laws of a country seems trivial in contrast to these more daunting challenges that exist regardless of whether the country is a signatory to a multilateral or a bilateral investment agreement.

## **7. Issue Linkage and the “Grand Bargain”**

The “grand bargain” argument is one of the *raison d’être* of the WTO. In a nutshell, what the WTO process does is to allow countries to define a negotiating set that allows a variety of potential tradeoffs and deals to be crafted that are superior to the status quo ante. Because countries are restricted to the equivalent of barter trade in multilateral trade negotiations, to achieve a Pareto superior (cooperative) outcome, issues must be linked. Determining when such linkage is necessary and successfully designing globally-beneficial packages is a non-trivial task, given that this occurs in the context of rent-seeking lobbying and often involves issues that are difficult to analyze (Leidy and Hoekman, 1993).

In the FDI policy context, the argument is quite simple—this is a valuable negotiating chip for developing countries as industrialized nations are the “demandeurs.” Indeed, insofar as governments are in a situation where domestic constraints inhibit the abolition of restrictive FDI policies, using this “chip” comes at zero cost. Given that for most developing countries FDI exports is largely a non-issue, a good case can be made that the *quid pro quo* for accepting to adopt national treatment, MFN, and the right of establishment as general multilateral disciplines should be sought outside the investment area. Examples that have been mentioned include antidumping and restrictive rules of origin (Moran, 1998). While valid in principle, it is not clear that investment policies are a particularly valuable “negotiating chip” for developing countries. Other policies are likely to be more powerful in inducing offsetting “concessions”. Among these, further liberalization of trade under existing agreements (GATT and GATS) figure prominently. Investment policies may prove useful at the margin, but much can already be (and will have to be) brought to the negotiating table by developing countries through utilization of existing mechanisms and instruments.

## 8. Strengthening the Architecture of the WTO

The current “architecture” of the WTO is quite messy: the WTO is an apex institution that oversees (embodies) three major multilateral agreements (GATT, GATS, and TRIPs), membership of which is mandatory, and several “plurilateral” agreements in which membership is voluntary. All three multilateral agreements focus on trade or trade-related policies. As is often emphasized in the literature, trade and investment have increasingly become complementary. This has been reflected in the WTO in various ways, perhaps most clearly in the GATS by defining trade as including “commercial presence” (i.e., FDI) as a mode of supply that is covered by the agreement. It is also noted often that it will become increasingly difficult to maintain a clear distinction between trade in goods and trade in services, as technology may give producers the choice of delivering their products in tangible form or in disembodied form. A priori, it would appear that any multilateral disciplines should apply equally to international transactions regardless of the mode of delivery.

A case can be made that WTO members may wish to consider developing disciplines that distinguish between trade and investment, with trade in goods or services being subject to a set of common rules, and movement of factors of production being subject to another set of rules. This in effect has been the approach taken in the NAFTA, which includes a separate chapter on investment (in goods or services), which is distinct from the rules relating to cross-border trade (in goods and services). Emulating this approach would result in much greater consistency and clarity of the applicable rules and disciplines.

This argument provides a compelling rationale for launching negotiations on FDI-related policies. Note that an implication is likely to be that movement of labor will be put on the table as well as movement of capital and know-how (FDI). Purely from an economic viewpoint, the arguments for free movement of labor are no weaker than those for the free movement of capital. Clearly, countries that play the role of source countries in the movement of capital will play the role of host countries in the movement of labor. A popular developing country perspective is precisely that if we are to put investment on the agenda of the WTO, why not also add the movement of natural persons?<sup>15</sup> This is a difficult issue and the implications of following such a path are far-reaching, as it involves a complete re-design of the WTO. Furthermore, the arguments involved would extend quite far from the usual political-economy considerations that figure prominently in other issues such as liberalization of trade in goods and services. It is unlikely that governments will be prepared to far down this path, given the fact that the WTO has only just been created and that the issues involved become considerably more thorny once labor mobility is introduced into the mix.<sup>16</sup>

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<sup>15</sup> See Panagariya (1998) for arguments in favor of movement of natural persons being part of the negotiating agenda from the developing country perspective.

<sup>16</sup> In fact, purely from an economic viewpoint, the first best allocation of world resources requires free mobility of capital and labor. Free trade in goods and services can deliver the first best under factor price equalization, but not otherwise (Krishna and Panagariya, 1997).

## 9. The OECD Negotiations on a Multilateral Agreement on Investment

Starting in 1995, the OECD initiated talks to create a Multilateral Agreement on Investment (MAI) that would liberalize investment and establish binding dispute settlement procedures. The OECD talks proved much more difficult than originally envisaged by participants, and broke down in late 1998, following a decision by France to cease participating in the negotiations. The reasons for the breakdown were manifold. Many governments proved unwilling to remove remaining restrictive policies (i.e., liberalize), leading to long lists of derogations and exemptions, which reduced the support of multinationals. Conversely, many NGOs were vehemently opposed to the MAI draft because they perceived it as giving too much power to foreign investors to contest host country regulatory policies that would have a detrimental impact on their investments through provisions on investor-State dispute resolution. The relevant provisions, which drew on those found in the NAFTA, gave foreign investors the right to sue governments for damages resulting from violations of the agreement. The concern was that investors would use these provisions to seek compensation for the costs associated with the imposition of domestic environmental, health and safety or zoning regulations after an investment had occurred (drawing on several cases brought by foreign investors against NAFTA governments) and that governments would be constrained in their ability to pursue regulation deemed to be in the national interest (Kobrin, 1998). Objections were also raised that the rights granted to investors under the MAI were not balanced by provisions laying out their responsibilities towards consumers, workers or the environment.<sup>17</sup>

Although much has been made of the investor-State dispute provisions of the MAI and the impact of a MAI on domestic regulatory sovereignty, much of the controversy is ill-conceived. There was nothing in the MAI (or in NAFTA) that prevents governments from pursuing regulatory policies—the main issue here was that foreign investors would be granted stronger rights to claim compensation than domestic counterparts. Clearly this is a matter that should be the subject of domestic debate. All governments must address the issue of compensating affected interests for regulatory “takings”. One option would have been to extend “MAI” rights to all affected parties; another to define when such claims may be made.

MAI negotiations were made more difficult as well because they went beyond FDI to cover intangible capital (know-how) and portfolio capital. Especially with respect to the latter many governments were unwilling to make binding commitments that might affect their ability to regulate such flows. Finally, many NGOs objected to the fact that MAI negotiations were undertaken by government officials who made little effort to engage or inform national legislatures and civil society more generally, while favoring business interests in terms of access and provision of information.

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<sup>17</sup> For an overview of the arguments made by NGOs against the MAI, see Vallianatos (1998).

In the end, OECD countries were only able to agree on a package that was less far-reaching than what is often found in the bilateral investment agreements between high-income and developing countries (Sauve, 1998), reducing the interest of the business community to push for the agreement. The vociferous opposition by a well-organized network of NGOs made a number of governments, particularly France, less inclined to move forward as well. What is particularly noteworthy from the perspective of this paper is that the MAI included no disciplines in the area of incentives. National treatment would apply to foreign investors, but any government could go beyond this and discriminate in favor of a foreign investor (by providing a subsidy). Together with the long lists of derogations to national treatment, this suggests that at least two of the potential rationales for international agreement were not satisfied in the MAI context.

## 10. Towards a WTO Agreement on FDI-Related Policies?

Investment has been proposed as a subject for future WTO negotiations. A recent WTO report on investment in the global economy concludes that:

“WTO members are confronted with a basic policy choice: Do they continue to approach the FDI issue as they have until now, that is bilaterally, regionally and plurilaterally, and on an ad hoc basis through sectoral and other specific WTO agreements; or do they seek to integrate such arrangements into a comprehensive and global framework that recognizes the close linkages between trade and investment, assures the compatibility of investment and trade rules and, most of all, takes into account in a balanced way the interests of all the members of the WTO—developed, developing and least developed alike. Only a multilateral negotiation in the WTO, *when appropriate*,<sup>18</sup> can provide such a global and balanced framework” (WTO, 1996, p. 59).

With the demise of the OECD-based efforts to negotiate a MAI, the WTO is the main game in town for those seeking to negotiate general rules on FDI, although some have argued in favor of UNCTAD. RIAs are clearly an alternative, but are an inferior instrument from a global perspective as they may distort the pattern of FDI flows, either by discriminating against investors located in non-members, or by creating incentives for FDI from any source to locate in a specific country. The latter can arise in so-called “hub and spoke” free trade agreements, where a country has a series of bilateral FTAs, but the various partner countries do not have FTAs with each other. In such situations investors may choose to locate in the “hub” country simply because this gives them access to all the “spoke” countries, not because it is the optimal location on economic fundamentals. An exception to this argument arises if greater credibility can be obtained through a regional than through a multilateral agreement. Although in principle this can be important (Fernandez and Portes, 1998), in practice it does not appear to apply to most

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<sup>18</sup> The italics have been added by us to emphasize that even the WTO document admits the possibility that the time may not be ripe yet for such negotiations.

RIAs extant, the Association Agreements between the EU and the Central and Eastern European countries being a possible exception.

A number of WTO agreements already embody or imply disciplines on investment-related policies (see WTO 1996 for a review). The TRIMs agreement contains language requiring a review of the agreement by 2000, which is to include consideration whether the agreement should be complemented with provisions relating to investment policies. A central question is whether the net gains of negotiating a feasible general agreement under WTO auspices are large enough. Alternatively put, the issue is to decide whether or not to continue the existing piecemeal approach. In answering this question it is useful to return to some of the key issues identified in the Introduction: what would an agreement do for developing countries in terms of fostering “good” FDI-related policies and generating better access to foreign markets through FDI; addressing negative international spillovers; enhancing policy credibility; and reducing transactions costs for multinationals and governments?

Most FDI takes place between high-income countries that have similar factor endowments. The fact that these flows of FDI occurred in the absence of multilateral disciplines raises immediate questions regarding the relevance of such an agreement. It could be argued that FDI flows would have been still higher if disciplines had existed. The policy environment across the developed world is on the whole more uniform than it is across developing countries, so that the value of implementing common rules governing FDI is potentially higher for them. FDI flows into such countries have increased substantially in the last decade; they now attract some thirty percent of the total (UNCTAD, 1996). However, the distribution is very skewed, reflecting that what matters in terms of attracting FDI are the fundamentals, including political stability, geography, natural endowments, an efficient infrastructure, good human capital, and liberal trade policies. An investment treaty will do little for countries in attracting FDI if these fundamental requirements are not in place.

Increasing access to foreign markets through FDI does not appear to be a priority issue for most developing countries. The important questions therefore are whether an agreement can help to reduce or offset the political impediments that constrain adopting domestic policies and procedures that will be more conducive to attracting FDI, and whether it can address international policy spillovers.

#### *Restrictive policies*

The TRIMs agreement does not address purely domestic policy regimes that raise the cost of market access or restrict establishment by foreign investors. As noted earlier, to be useful to countries that face difficulties in reforming the regulatory and business environment, the process of negotiating an investment agreement must allow issues to be brought to the table that are of sufficient interest to domestic constituencies for them to invest resources to fight for a better investment regime. Necessary conditions are that there are restrictive policies that have proven impossible to eliminate unilaterally, and



that there are issue linkages that can break the domestic deadlock. Foreign pressure for market access may be enough in itself, but generally source country interest groups seeking such access will have to bring something to the table to motivate constituencies in host countries to assist them. The regional experience suggests that as far as developing countries are concerned it may not be easy to devise such an agreement—most do not go much beyond the WTO. The OECD experience illustrates that limiting attention to investment policies only can be a recipe for failure—the agenda needs to be broader to allow tradeoffs and issue linkages. If so, a multilateral agreement that embodies disciplines on the regulatory environment might prove valuable to developing countries that confront difficulties in removing redundant red tape unilaterally.

That said, one can ask what deserves priority. From an economic perspective we would argue that priority should focus on eliminating entry restrictions. These are mostly binding in service industries. As noted previously, red tape restrictions on inward FDI may be motivated in part by the existence of high trade barriers. If so, priority should be given to trade liberalization to facilitate imports. Liberalization of FDI restrictions and procedures is most important for non-tradables. The key need therefore is to continue the process of multilateral liberalization of trade, focusing particular attention on reducing the extent of discrimination by expanding the coverage of specific commitments for services markets under the GATS, which already covers investment as a mode of supply.

### *International policy spillovers*

Turning to the systemic issue of international policy spillovers, a potentially strong argument in favor of a multilateral agreement is that it could help avoid mutually destructive policies from the viewpoint of developing countries eager to attract FDI via the use of incentives. As noted in Section 3, we regard the economics of the negative spillover case as being weak. For one, a number of studies find that fiscal incentives have little if any impact on the location decisions of foreign investors. Even if one does not accept this conclusion—and clearly the jury is still out—it is not clear there is an international public good case for cooperation. Competition (non-cooperation) could be welfare improving for the world as a whole (Bond and Samuelson, 1986; Caves, 1996). Nevertheless, one should be careful to distinguish the efficiency issue from the issue of transfer of rents: competition for FDI may lead to an efficient outcome but yet fail to be in the interest of the developing countries competing for such investment. Of course, the argument for policy coordination then amounts to collusion between developing countries in order to restrict transfers to multinational firms, and is therefore, on weaker grounds.

Moreover, to be effective in disciplining the use of firm-specific fiscal incentives, any agreement arguably would need to be quite comprehensive. It would need to cover not only firm-specific investment incentives, but also taxation, competition regimes, and deal with the discrimination that is created by RIAs to ensure countries cannot side-step the disciplines on financial incentives through the use of such policies. The GATT/WTO negotiating and implementation history illustrates that agreement on subsidy and related disciplines is very hard to obtain, and that disciplines are easily circumvented. Even RIAs

such as the EU—which go much further than the WTO in this area—have encountered recurrent difficulties associated with government policies intended to attract FDI. NAFTA does not even try to tackle this issue.

## 11. Concluding Remarks

Negotiating a WTO agreement on investment policies may prove useful in arriving at a “grand bargain” that extends to issues of particular interest to developing countries. This possibility must be considered carefully, as there may be significant scope for obtaining large returns in other areas as a *quid pro quo* for participating in an investment agreement. A broader agenda will be necessary both for countries that confront domestic political economy constraints on the adoption of better FDI policies, and for those that seek to use FDI policies strategically. Devising a grand bargain will be difficult. Account must be taken of the potential downside—issue linkage can be a two-edged sword. Efforts to expand the agenda may allow groups in society to seek cross-issue linkages in areas such as the environment or labor standards that could be detrimental to the original *raison d’être* of the WTO: to progressively liberalize international trade. Bhagwati (1998) has argued that this Pandora’s box possibility provides a powerful justification for leaving general investment rules off the WTO agenda.

The failure of the OECD to reach an agreement on a MAI illustrates the practical difficulties that will arise. The diversity in the policy environment across countries creates significant room for skepticism regarding the success of negotiations regarding an agreement on investment. If OECD countries, with their much more uniform policy environment and similar goals fail to reach an accord, how can one expect developing countries that differ more substantially from one another to agree on a common set of principles regarding investment?

In our view priority should be given to the pursuit of “classic” trade liberalization to ensure markets for tradable goods are contestable through exports. This should include efforts to liberalize access to service markets on a nondiscriminatory basis, an area where establishment (FDI) is often crucial. Continued nondiscriminatory liberalization of trade barriers for goods and services will also help reduce possible locational distortions for FDI resulting from RIAs and discipline the ability of countries to pursue strategic policies, as trade policy is a vital element of any such strategy. While the elimination of trade policy as an instrument to transfer profits is in theory possibly detrimental to developing countries, in practice such policies are very difficult to design and implement. Any potential losses are likely to be offset many times over by the efficiency gains from trade liberalization. Moreover, countries obtain compensation in a mercantilist sense as well, as trade liberalization in foreign markets will be obtained as a *quid pro quo*.

The fact that the GATS includes establishment as a mode of supply on which commitments can be made significantly weakens the economic case for making a stand-alone investment agreement in the WTO a negotiating priority. Once substantial further progress has been made to liberalize trade in goods and services on a nondiscriminatory

basis, including market access through establishment in (nontradable) service activities, it will become much clearer whether the potential benefits of seeking general rules on investment policies are large enough to justify launching a multilateral negotiation in this area. While we support the applicability of general WTO principles such as national treatment, MFN, transparency etc. in the area of investment, our point is simply that such principles can already be implemented within existing agreements. The rather limited applicability of the national treatment instrument in the GATS suggests that this is not the appropriate time to consider launching negotiations on investment policies.

Although we are pessimistic about the need for—and feasibility of—negotiating a multilateral agreement on investment at this time, the conclusion that new multilateral rules are not really needed is a positive one. It implies that governments can achieve much of what is beneficial unilaterally—including application of the principles of national treatment and MFN, and adoption of the right of establishment in national law. It also implies governments do not have to invest resources to negotiate in (another) new area and can instead use existing institutions and mechanisms to liberalize access to markets. Over time, the architectural argument in favor of common disciplines for trade in goods or services, and common rules relating to the treatment of foreign factors of production, will become stronger. The more trade barriers and barriers to establishment in services have been reduced in the interim, the greater the feasibility of undertaking a general overhaul of the WTO may become.

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